ASSESSMENT OF COMPETITION IN THE ILLINOIS ELECTRIC INDUSTRY: FINDINGS AND RECOMMENDATIONS

ILLINOIS COMMERCE COMMISSION

January 2003

Executive Summary

The Commission hereby submits to the General Assembly the triennial report required by Sec. 16-120(a) of the Public Utilities Act ("Act"). This is the second report that the Commission has submitted pursuant to Sec. 16-120(a). The Commission's previous report was submitted in January 2000.[1]

According to Sec. 16-120(a), the Commission:

> … shall monitor and analyze patterns of entry and exit, applications for entry and exit, and any barriers to entry or participation that may exist, for services provided under this Article; shall analyze any impediments to the establishment of a fully competitive energy and power market in Illinois; and shall include its findings together with appropriate recommendations for legislative action in a report to the General Assembly.

The report examines the status of Illinois retail and wholesale power markets and barriers to entry to these markets. The report concludes that competition has not fully developed in either the wholesale or the retail markets, and identifies impediments to the development of both markets. Finally, the report recommends policies that could remove or mitigate the negative competitive effects of the impediments.

Such policies as increasing the number of independent entities that own generation in a service area and eliminating disincentives for expansion of the transmission grid may be necessary to support competitive markets at the wholesale level. Policies that would stimulate customer and supplier interest and participation in customer choice are needed to address obstacles to competition in retail markets.

The report emphasizes that the wholesale market is critically important to all participants in the Illinois electric market. Retail competition will not evolve until suppliers can rely on a competitive wholesale market to provide the products they wish to sell to retail customers. The wholesale market is equally important, however, to the customers who will continue to purchase electricity from the incumbent utility because bundled rates eventually will be based primarily on wholesale market prices. To keep prices for all customers at reasonable levels, it is imperative that utilities purchase power and energy in a competitive wholesale market for the customers who do not choose alternative suppliers. As of the end of 2002, however, it is uncertain that the wholesale market will produce competitive prices in the foreseeable future or even by January 2007, when the existing freeze on bundled retail rates terminates.

The Commission's concern about the status of the wholesale market stems from the structure of the Illinois electric industry, in which holding companies own or control most of the generating capacity in each service territory in addition to transmission and distribution facilities. Generator

[1] The Commission also submits annual reports to the General Assembly under Sec. 16-120(b) assessing the state of electricity markets.

ownership is highly concentrated in most utility service areas, and electric utilities have little incentive to increase generation ownership diversity by encouraging independent generator entry into generation markets or increasing transmission import capacity. Since only one or two entities own the majority of generating capacity in each service area, aggressive price competition between generators is unlikely under present concentration levels.

Another concern is the adequacy of the existing transmission system to enable Retail Electric Suppliers ("RESs") to access remotely located supply sources that are less expensive than the generation located within the service area. Since much of the generating capacity in the largest service territories is owned by utility affiliates, utilities have little incentive to expand transmission capacity. The rate freeze that is currently in effect may also create a disincentive to adding new transmission capacity, since new transmission investments costs cannot immediately be recovered in their entirety from bundled retail customers.

Another impediment to the development of a competitive wholesale market for electricity in Illinois is the lack of transparency in the current wholesale market design. The information and liquidity requirements necessary to support a truly competitive electricity market, particularly one that includes retail access, are steep relative to those that have historically served the vertically integrated utilities under traditional regulation.

The absence of a dependable and transparent regional wholesale power market is directly related to the lackluster growth of retail competition in most areas of the State. As of September 30, 2002, about 25,000 customers, or only about 6.5% of all non-residential customers, have switched to delivery services or, as permitted by Sec. 16-116 of the Act, signed a discounted rate power and energy contract with the incumbent electric utility. The customers switching to delivery services are located only in the three largest service areas of the State (AmerenCIPS, ComEd and Illinois Power). However, the vast majority of delivery services customers are located within the ComEd service area. In the service areas of the State's six smallest electric utilities, customers and suppliers have exhibited little or no interest in delivery services. Customer switching among residential customers is nonexistent throughout the State.

Delivery services activity in the ComEd service territory has been split between RES supply and the Power Purchase Option ("PPO"), a power and energy service that utilities that impose transition charges must by statute offer to their non-residential customers. RES activity has been comparatively minimal in the service areas of AmerenCIPS and Illinois Power, where customer interest in delivery services centers almost exclusively on the PPO. However, there is a considerable question as to whether customer movement to PPO service should be taken as a strong indicator of competitive activity, even though PPO customers are by definition delivery services customers.

Table 1 shows the supply selections chosen by non-residential customers as of September 30, 2002. The table indicates that only a relatively small

fraction of customers have taken advantage of the options created by Article XVI of the Act.

Table 1: Nonresidential Supply Selections in 2002

Electric Utility	Total Eligible Customers	Power Purchase Option	RES Supply	Section 16-116 Contract	Total
AmerenCIPS	47,441	544	193	16	753
AmerenUE	8,622	0	0	0	0
CILCO	36,332	NA[2]	0	536	536
ComEd	329,367	8,797	12,770	26	21,593
Illinois Power	66,037	976	16	1,332	2,324
Interstate Power	2,532	NA	0	0	0
MidAmerican	10,490	NA	0	11	11
Mt. Carmel	968	NA	0	2	2
South Beloit	933	NA	0	0	0
Total	**502,722**	**10,317**	**12,979**	**1,923**	**25,219**

In addition to wholesale market issues, other obstacles hinder the development of retail competition. The existence and volatility of transition charges, in particular, have retarded retail competition in the service areas where utilities impose transition charges on customers who switch to delivery services. Transition charges limit the savings available to customers to approximately the "mitigation factor,"[3] currently about 8-10% of a customer's bill, a level of savings that may not be sufficient for many customers to consider switching to delivery services. Moreover, the yearly variability of market values and transition charges has made customers wary of signing long-term contracts, especially after the large increases in transition charges between 2001-2002.

Other impediments include the PPO, which, while providing benefits to customers, presents an obstacle to suppliers because customers can expect to obtain about the same amount of savings (less an administrative fee) by

[2] "NA" means the electric utility does not offer the service.
[3] The mitigation factor schedule is described in Sec. 16-102.

switching to the PPO as by purchasing power from RESs. In addition to the PPO, suppliers face other retail market impediments. The Act's reciprocity provisions has prevented some unknown number of suppliers from even entering the market, and a recent Appellate Court ruling could further limit the number of suppliers that could qualify to serve retail electric customers.[4] Suppliers also must contend with customer rates in many areas of the State that are already low by current market standards. In some service areas, particularly the CILCO service area, electric utilities aggressively signed up hundreds of potential delivery services customers, keeping the customers off the market for years at a time.

Given all of these problems, it is perhaps not surprising that the development of a competitive retail market will take longer than might have been expected in December 1997. Prospects for a competitive retail market may brighten by the end of 2006, however. At that point, the existing bundled retail rate freeze will expire, providing electric utilities an opportunity to seek an increase in the rates charged to bundled service customers. Furthermore, the end of 2006 now coincides with the end of the period during which customers leaving bundled service can be charged transition charges. Conceivably, bundled rates could rise from present levels at the end of the rate freeze, depending on prices in the wholesale market at that time. Alternative suppliers, which are currently finding it difficult to undercut the generation price implied in the bundled rate in several service areas and for particular customer classes, may find it easier to compete against presumably higher utility bundled rates after the expiration of the rate freeze and transition fees. However, even under the conditions of higher bundled retail rates and no transition charges, a retail market will have little chance of succeeding unless the wholesale market is reasonably competitive at that time.

The Commission is concerned that the alternative suppliers now operating in the market will eventually lose interest in the Illinois electric market and may no longer be around when the transition period ends. The number of active alternative suppliers has been basically stagnant recently, rather than growing, and the few new suppliers have acquired only a small number of customers. For retail competition to have a good chance of succeeding after 2007, it essential that at least a minimum number of alternative suppliers maintain a presence throughout the remainder of the transition period, so as to be prepared to rapidly expand operations when the transition period ends and market conditions, hopefully, will have improved.

The Commission has concluded that the following policies would encourage customer and supplier interest in retail competition and enhance the possibility that the wholesale market can become competitive, for the benefit of all Illinois electric customers. Some of the recommendations are aimed at the transition period and others are applicable to both the transition period and the post-transition period. Many of the recommendations seek to address

[4] 331 Ill. App. 3d 607, 772 N.E.2d 340, 265 Ill. Dec. 302 (Fifth District, 2002).

fundamental impediments to the development of wholesale competition, within the State's ability to address such matters. The recommendations made by this report are as follows:

- **Recommendation 1: Require Illinois Utility Membership in Properly Designed and Configured RTOs**
  Short of restructuring to corporately separate transmission ownership and operations from market functions, Illinois utility membership in properly designed and configured regional transmission organizations provides the next best means of mitigating the negative effects of conflicts of interest between utility transmission operation and utility-affiliated market interests. This recommendation should be implemented to the fullest extent consistent with Sec. 16-126(k) of the Act.

- **Recommendation 2: Readdress Functional Separation Issues**
  Given the impediments that affiliated interests can place on the development of both retail and wholesale competition in Illinois, there is a great need to readdress the issue of functional separation between regulated utilities and their unregulated affiliates.

- **Recommendation 3: Allow New Transmission Investments on the Basis of the Promotion of Competition**
  In adopting Article XVI of the Act, the General Assembly directed the Commission to promote competitive electric markets as the means to advance the public interest. The facility certification provisions of Article VIII should be revised to reflect that pro-competition directive.

- **Recommendation 4: Greater Oversight of Utility Asset Transfers**
  Sec. 16-111 allows the generation ownership concentration that was developed under a comprehensive regulatory regime to continue undiluted into the new era in which policy-makers are attempting to facilitate competitive markets. This statutory provision could permit generation ownership concentration levels to increase precisely at the time when competitive market development depends upon concentration decreasing.

- **Recommendation 5: Require Competitive Bidding for Bundled Supply**
  Open bid supply auctions would facilitate the development of wholesale competition to serve bundled load and provide a more transparent marketplace.

- **Recommendation 6: Modify Sec. 16-111 to Permit the Commission to Set Non-Discriminatory Stand-By Rates**
  Distributed generation will not be able to compete with traditional supply options if distributed generation owners are required to take supplemental power under discriminatory backup or stand-by tariffs.

- **Recommendation 7: Do Not Permit Electric Utilities to Reject Commission Market Value Decisions**
  The Act establishes methods for the determination of market values to be used in the transition charge calculation and as an input to the price of PPO services. The ability of electric utilities that impose transition charges to refuse to implement Commission decisions concerning market values and transition charges results in unnecessary uncertainty for market participants.
- **Recommendation 8: Modify the Act To Permit Electric Suppliers to Use Telemarketing-Based Customer Enrollment Methods**
  With appropriate safeguards, telemarketing enrollment methods could encourage alternative suppliers to serve small-use customers by reducing customer acquisition costs.
- **Recommendation 9: Eliminate the 24-Month Minimum Enrollment Requirement in Sec. 16-103(d)**
  This provision enables electric utilities to keep former small-use delivery services customers from returning to delivery services for up to 24 months. Elimination of the provision would benefit customers and suppliers at little or no cost to utilities.
- **Recommendation 10: Consider Implementation of Municipal Aggregation**
  Municipal aggregation has been successfully adopted in other states as a means to enable large numbers of residential customers to take part in customer choice programs.

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I. Introduction

The 1997 Amendments to the Public Utilities Act ("1997 Amendments") granted customers the opportunity to purchase electricity from qualified alternative suppliers or through the Power Purchase Option ("PPO") by taking delivery services offered by electric utilities. By the end of 2002, some 23,000 customers have exercised the option to switch from traditional bundled service to an alternative service. Just as important to the future Illinois electric industry as the inception of customer choice, however, was the freedom given to electric utilities to restructure their companies, under relatively little oversight from the Commission. The largest electric utilities have taken advantage of these opportunities. Utilities have sold or transferred their generating plants (and, recently, proposed to sell transmission assets)[5] to affiliated or unaffiliated companies and merged with other Illinois or non-Illinois utilities.

The success of retail choice and retail competition in Illinois will, to a large extent, depend on the consequence of these restructuring activities, as the generation sales and transfers have resulted in electric utilities and their customers being dependent on the wholesale power market, rather than on utility-owned and operated, rate-based generating facilities. Thus, it is of paramount importance that generators now controlling the generating capacity in Illinois operate in a competitive marketplace prior to the expiration in 2007 of the retail rate freeze that is currently in effect. However, the State's ability to influence prices charged in the wholesale market is limited. Even though the Commission retains authority over the terms, conditions, and rates for bundled retail service and the distribution component of delivery services, the Commission has no direct authority over the price of wholesale electricity sold to utilities for resale to bundled customers or of electricity sold directly to retail customers via delivery service tariffs. Similarly, the Commission's authority over electric transmission in interstate commerce is quite limited. The 1997 Amendments authorized utilities to restructure their operations in such a way as to remove all generation pricing decisions and many other decisions from Commission jurisdiction. As a result, Illinois must now rely on the Federal Energy Regulatory Commission ("FERC") to ensure reasonable prices in the wholesale electricity market. FERC has recently attempted to implement independent transmission operators and standard market design, but it is unclear whether these measures will succeed in providing the necessary structures for the development of a competitive wholesale market.

The Commission's concerns about the development of wholesale competition stem in part from underlying market imperfections. Of particular concern is the close corporate relationship between electric utilities and their generating affiliates. Such relationships provide incentives for utilities to advantage their generating affiliates by, for example, discouraging independent generator entry.

[5] Docket Nos. 02-0742, 02-0743 and 02-0748.

Another concern is the high degree of generator concentration within service territories, coupled with limitations in the electric transmission links between geographic areas. The high level of generator concentration has resulted from provisions in the Act that give utilities virtually unrestricted authority to transfer or sell assets, leaving generation concentration within utility service territories at the nearly the same levels as prior to adoption of the 1997 Amendments. Also, the ability of outside generation to compete for load is limited by a transmission system that was developed to permit utility generation to serve utility load, not to enable RESs to import competing power supplies. Unless generation ownership concentration is diluted and/or transmission is developed to permit greater movement of competing power supplies into utility service territories, Illinois can expect future inefficient power supply pricing and higher prices for consumers than a competitive market would deliver.

The lack of transparent, competitive wholesale markets in most areas of the State is a major reason why retail markets have not developed as quickly as expected. However, while a competitive wholesale market is a necessary condition for a competitive retail market, it is not the only factor hindering the development of the retail market. In the service areas where transition charges are charged to customers switching from bundled service to RES supply, unpredictable and volatile market values have resulted in equally unpredictable and volatile transition charges. Consequently, due to the difficulty in hedging against price movements, customers and suppliers have very little ability to accurately forecast future electricity costs, making customers leery of signing up for multi-year power and energy deals with alternative suppliers. For example, some of the customers in ComEd's territory that did agree to multi-year deals found to their chagrin that unexpected movements in transition charges resulted in total electricity bills that were higher than the bills they would have paid under traditional bundled service. Of course, in addition to providing an impediment to the development of retail competition, the mere existence of transition charges deprives customers of the full measure of the limited price benefits that the wholesale market is currently producing.

An additional problem with existence of transition charges is that they coincide with the provision of PPO service. While the PPO can produce lower electric bills for some (but not all) non-residential customers, the PPO can be underpriced, relative to RES costs of service, particularly if market values are inaccurately estimated or market conditions change after market values are set. Most suppliers cannot expect to compete against the PPO if the wholesale market price for power spikes after the market value is set. For example, unexpected changes in transition charges and the market values led to ComEd, or its affiliate, offering inducements to the suppliers operating in its territory to discourage customers from returning from RES supply to ComEd-offered PPO supply.

It is now evident that retail competition may be a long time developing in most areas of the State. In some cases this is merely because bundled rates in some service areas are already very low compared to the rates that alternative

suppliers can offer. In these circumstances, the lack of entry by potential competitors in some markets are not so much a sign of barrier to entry, as a sign that alternative suppliers have nothing to offer retail customers taking service from their utility. In others instances, retail development is being hampered by artificial barriers. For example, the reciprocity provisions of Sec. 16-115(d)(5) of the Act restrict the number of suppliers who can qualify to serve customers in Illinois.

It should be clear from this discussion that, despite the ongoing efforts of the General Assembly, the Commission and the FERC to address impediments to competition, much remains to be done before wholesale and retail markets can be considered to be sufficiently competitive to protect the interests of retail customers. It is not even certain that these markets will be competitive prior to the expiration of the rate freeze in 2007. If it becomes increasingly evident as 2007 approaches that neither market is competitive, the State should consider whether dropping existing protections against immature markets, such as the rate freeze, would harm electric customers. In the meantime, Illinois should do all within its authority to remove competitive market barriers and should continue to encourage federal officials to carefully monitor developments in wholesale markets and move quickly to improve competitive market structures.

II. Status of the Wholesale Electric Market in the Midwest

The Federal Power Act gives the Federal Energy Regulatory Commission authority over all wholesale power sales by public utilities and all transmission of electricity by public utilities in interstate commerce. Since at least 1996, FERC has very actively advanced an agenda to introduce and promote competition in wholesale power markets as a substitute for traditional regulatory methods of ensuring just and reasonable rates.

In 1996, FERC issued Order 888, which was a major milepost in FERC's efforts to move the electric industry toward a more competitive framework. Order 888 required all FERC-jurisdictional electric utilities to provide open access to their transmission lines so that wholesale purchasers could access suppliers of electricity other than their local monopoly utility. While it was a major advancement, wholesale open access, by itself, was not enough to prevent electric utilities from operating their transmission systems in ways that provided unfair preferences to their own wholesale sales of electricity or the wholesale sales of electricity by their marketing/generating affiliates. A competitive power market cannot develop where discriminatory preferences operate.

Consequently, in 1999, FERC issued Order 2000. Order 2000 urged all transmission-owning electric utilities to join regional transmission organizations ("RTOs"). The goal was for each electric utility to transfer operational control of transmission facilities, if not outright ownership, to an independent regional entity so that all market participants, including the electric utility itself, could participate on an even footing in the wholesale power markets. Unfortunately, however, FERC made compliance with the goals of Order 2000 voluntary for electric utilities, rather than mandatory. As a result, RTO formation and development has

been slower than some had hoped. The other major deficiency in Order 2000 was that it failed to draw a clear picture of a desired market structure. It also failed to prescribe a detailed market design and it failed to require RTO operation of a transparent wholesale marketplace.

FERC is currently in the process of attempting to address these Order 2000 deficiencies so as to further remove, or at least mitigate, the negative effects of electric utility discriminatory practices with respect to the transmission system and to better facilitate regional competitive wholesale power markets by prescribing a standard framework. In particular, on July 31, 2002, FERC issued its Standard Market Design Notice of Proposed Rulemaking ("SMD NOPR"). The SMD NOPR proposes to require (i.e., mandate) electric public utilities to transfer operational functional control of their transmission facilities to an independent entity. It would also require adoption of a single standardized form of network access transmission service. The SMD NOPR would also require security constrained, bid-based markets using locational marginal pricing ("LMP") with financial congestion revenue rights as the standardized market design to be operated by the RTOs on a regional basis. The SMD NOPR would also institutionalize a formal market monitoring process and require a generation supply adequacy margin as ways to address possible exercises of market power and dampen wholesale price volatility. FERC hopes to issue a final rule in the SMD NOPR proceeding in 2003.

FERC's pro-competitive efforts have produced some positive effects in the Midwest region. For example, the Midwest ISO, which operates in multiple states and one Canadian province, began some transmission system operations in February 2002. CILCO is currently the only major Illinois electric utility whose transmission system operations are under the control of the Midwest ISO. However, other Illinois utilities, including Ameren, may soon transfer functional control of their transmission facilities to the Midwest ISO, either directly or indirectly through an intermediary. The Midwest ISO plans to initiate LMP market operations along the lines of FERC's SMD NOPR proposal in 2004.

In addition, the PJM Interconnection, which is an independent system operator ("ISO") currently operating in the Mid-Atlantic region, has plans to expand into the Midwest by reaching agreement with American Electric Power Company (AEP") and ComEd on terms for exercising functional control over those companies' transmission facilities. PJM plans to initiate transmission operations and market operations on behalf of these companies on a phased schedule in 2003.

To sum up, an operating, transparent, regional competitive wholesale power market is a prerequisite that must be developed in order for Illinois' open access retail program to provide any significant benefits to retail customers. Indeed, given that the 1997 Amendments allowed generating plants previously owned by electric utilities and under the jurisdiction of the Commission to be transferred to non-utility entities, responsibility for ensuring that sales from those plants are just and reasonable has moved under FERC's jurisdiction and into the wholesale market. To a great extent, Illinois, by adopting the 1997 Amendments,

has placed its trust in FERC to ensure just and reasonable rates in Illinois. FERC's primary philosophy is to use competition, rather than traditional regulation, as the mechanism for producing just and reasonable rates. That primary philosophy is tempered by the recognition that certain utility services, such as transmission, are likely to remain monopoly services for at least the near future. The philosophy is also tempered by the realization that unfettered competitive markets do not always produce desirable outcomes if a competitive market structure is not in place.

FERC has made much progress since 1996 toward realizing its wholesale competitive market goals. However, the task is gargantuan and the difficulties and impediments numerous. The goal has not yet been reached. The retail rate freeze that is currently in place in Illinois currently provides some protection for retail customers from the negative consequences of insufficient competition in the regional wholesale power market. However, the sense of urgency for accelerated progress in regional wholesale competitive power market development is real given the current December 31, 2006 deadline for expiration of the retail rate freeze.

III. Status of the Retail Electric Market in Illinois

This section discusses supplier and customer activity in the retail electric market.

A. Patterns of Entry: Retail Electric Suppliers

Sec. 16-120(a) directs the Commission to report on patterns of entry to Illinois markets. This section of the report describes the entities that are authorized to participate in customer choice by selling power and energy to retail customers. There are two types of such entities: (1) Suppliers that have sought and obtained Alternative Retail Electric Supplier ("ARES") certification from the Commission, and (2) Illinois electric utilities, which, under Sec. 16-116 of the Act, are permitted to sell power and energy to customers outside their service areas. Collectively, suppliers serving retail electric customers under delivery services tariffs are termed "Retail Electric Suppliers" or "RESs."

1. Applications from Alternative Retail Electric Suppliers

Sec. 16-115 of the Act establishes the standards that a prospective ARES applicant must meet to obtain certification from the Commission. Among other things, this section of the Act requires a successful applicant to demonstrate to the Commission its "technical, financial and managerial resources and abilities" to provide service to retail customers. The Commission adopted rules at 83 Ill. Adm. Code 451 to implement Sec. 16-115 and guide the ARES certification process.[6]

Utility affiliates who wish to sell power and energy must also receive certified status as an ARES. Utilities and their affiliates are subject to 83 Ill. Adm.

[6] Docket Nos. 98-0544 and 98-0649.

Code 450, the rule governing utility/affiliate relations that the Commission adopted pursuant to Sec. 16-121 of the Act.

A prospective ARES' application must identify each area in which it intends to serve and most applicants have sought certification in all of the state's service areas. Also, each application must specify the customer groups that the ARES hopes to serve. Based on Part 451, applicants may obtain certification to serve any of the following customer groups: (1) all non-residential customers; (2) all non-residential customers with greater than 15,000 kWh annual usage; (3) only customers with demand greater than one MW; and, (4) residential customers. Most ARES have applied to serve all non-residential customers, although a few applicants have only sought certification to serve one MW or greater customers. No applicant has applied to serve residential customers.

Additionally, Commission authorization for potential ARES intending to offer the single billing option described in Sec. 16-118(b) of the Act is obtained during the ARES certification process. As of September 30, 2002, only two entities have received certification to offer single billing services.

2. Electric Utilities Serving Outside Their Service Areas

When the market opened in 1999, only AmerenCIPS, CILCO, Illinois Power, MidAmerican and South Beloit expressed an interest in serving outside their home service areas. Currently, only CILCO and MidAmerican still market outside their service areas; AmerenCIPS serves a single customer; and Illinois Power and South Beloit apparently have exited the retail electric supply business outside their service areas. The State's remaining electric utilities, AmerenUE, ComEd, Interstate Power Company, and Mt. Carmel, have not marketed power and energy outside their service areas.

Unlike an ARES, electric utilities are not required to obtain Commission certification to offer customers the single billing option. However, electric utilities offering service outside of their traditional service areas must comply with the same single billing tariffs applicable to ARES.

Regulations adopted by the Commission governing supplier behavior are designed to ensure that the regulations apply equally to all RESs (except to the extent that certain statutory provisions may apply to only one or the other supplier category).

3. Active Retail Electric Suppliers

A total of about 21 suppliers are qualified to sell power and energy to retail customers eligible for delivery services. Of these suppliers, 13 suppliers were active in 2002 (that is, actually made electricity sales). All but two of the active suppliers are either Illinois electric utilities or an affiliate of an Illinois natural gas and/or electric utility. Only about one-half of the active suppliers have acquired more than 100 customers. A list of qualified suppliers, and the service territories in which they are qualified to serve, is provided in the Appendix to the report.

Most suppliers continue to concentrate their marketing efforts in the ComEd service territory only. Eight suppliers sold power and energy in the ComEd area during 2002 (see Table 2). Four suppliers sold power and energy to downstate (AmerenCIPS and Illinois Power) customers.

Table 2: Number of Active Retail Electric Suppliers During 2001 and 2002, by Service Territory

Electric Utility	Number of Active RESs in 2001	Number of Active RESs in 2002
AmerenCIPS	2	4
ComEd	7	8
Illinois Power	3	2
MidAmerican	1	0
All Others	0	0

B. Supply Options Chosen by Retail Customers[7]

This Section describes the legislatively created options available to non-residential customers for the purchase of power and energy. Also provided in this Section is information demonstrating the extent of delivery services activity.

1. Customer Supply Options

The Act recognizes several distinct customer power and energy supply options. Customers may opt for purchases from RESs or continue taking bundled service from the incumbent electric utility under frozen rates.[8] The Act allows electric utilities to offer power and energy contracts to any of their customers without Commission approval.[9] These discretionary contracts offered by utilities are essentially bundled service contracts that are discounts from the standard bundled rate.

Sec. 16-110 of the Act requires utilities that impose transition charges to offer PPO service. The PPO offers customers the option of unbundled service from the utility at market-based power and energy prices. Customer savings are a function of the mitigation factor, the customer's load factor and any administration fee imposed by the utility. Currently, the mitigation factor is the

[7] Data is current as of September 30, 2002.
[8] Customers may also generate power on their premises.
[9] See Sec. 16-116.

greater of 0.5 cents per kWh or 8% of the customer's base or contract rate. In 2003, the mitigation factor will increase to 0.6 cents per kWh.

Sec. 16-106 permits electric utilities to offer experimental programs for the "provision or billing of services on a consolidated or aggregated basis, as well as other experimental programs." The design of the experimental programs, choice of participants and participation inducements are at the discretion of the utility offering the program. Sec. 16-106 does not require utilities to offer a standard supply option to all customers, because implementation of such programs is left to the discretion of the electric utility. AmerenCIPS, AmerenUE, ComEd, and Illinois Power have offered load curtailment programs under Sec. 16-106, generally to large-volume customers.[10] ComEd has implemented several other experimental programs to well-defined customer groups. AmerenUE offered an experimental program to low-income customers. However, due to the adoption of 83 Ill Adm. Code Part 452 and the inability to prevent undue discrimination, most experimental programs are being phased out.

Sec. 16-107 of the Act requires electric utilities to offer to non-residential customers real time pricing service. Real-time pricing service, as provided in the Act, is bundled service in which prices vary on an hourly basis throughout the day. The customers that have the greatest potential to benefit from a "real-time" pricing tariff are the customers with the capability to control electric consumption and take advantage of off-peak electric prices. The statutorily required real-time pricing tariffs became effective October 1, 1998. Currently, only one customer is taking this real-time pricing service. It is likely that the exceptionally high energy prices during recent summers have made this form of real-time pricing appear to be a high-risk venture that customers are not willing to undertake at this time.

2. Customer Supply Selections

Table 3 below shows the number of customers who have chosen each of the supply options created by the Act, as of September 30, 2002. It is evident from this table that only a small percentage of customers have taken advantage of the available alternative supply options. Only customers located in three of the State's nine electric utilities have chosen any of the alternative supply options. However, the fact that over 23,000 customers of these utilities are taking delivery services, either by purchasing power from a RES or through the PPO, indicates that a substantial number of customers are interested in moving away from traditional bundled retail service.

ComEd customers have been the most active consumers of the supply options created by Article XVI. A total of 12,770 customers have switched from the incumbent utility to service from a RES, and an additional 8,797 customers have switched to service under the PPO. ComEd has signed relatively few customers to discretionary contracts. ComEd has implemented 14 experimental programs pursuant to Sec. 16-106, but participation in these programs has been

[10] The Commission is required by Sec. 16-106 of the Act to describe each experimental program initiated by an electric utility under Sec. 16-106 in an annual report to the General Assembly. The Commission's has submitted four such reports.

falling as the customers participating in these programs switch to delivery services. Additionally, as a consequence of the Commission's adoption of Ill Adm. Part 452, which restricts the ability of electric utilities to offer incentives to encourage customers to forgo delivery services, ComEd has cancelled several of its programs. As of September 30, 2002, no customers were purchasing power and energy from ComEd under Sec. 16-106 programs.

Illinois Power customers have exhibited an interest in delivery services almost exclusively through their selection of the PPO, as only 16 of IP's approximately 1,000 customers taking delivery services are purchasing from a RES. Illinois Power signed up hundreds of customers to discretionary contracts. These customers may not be able to take advantage of delivery services until the expiration of their IP contracts.

In the AmerenCIPS service territory, the majority of the approximately 750 AmerenCIPS delivery services customers are now taking PPO service. AmerenCIPS has signed 16 customers to discretionary contracts. No customers in the CILCO service territory have taken delivery services. CILCO signed a number a large number of customers to discretionary contracts under Sec. 16-116, but the number of customers under contract with CILCO has decreased during the past few years.

Table 3: Customer Supply Selections in 2002[11]

Utility	PPO	RES Supply	Sec. 16-116 Contract	Total
AmerenCIPS	544	193	16	753
AmerenUE	0	0	0	0
CILCO	NA[12]	0	536	536
ComEd	8,797	12,770	26	21,593
Illinois Power	976	16	1,332	2,324
Interstate Power	NA	0	0	0
MidAmerican	NA	0	11	11
Mt. Carmel	NA	0	2	2
South Beloit	NA	0	0	0
Total	10,317	12,979	1,923	25,219

3. Customer Switching Statistics

Table 4 and Table 5 provide additional information about non-residential customers' selection of delivery services. The tables show that only a small percentage of customers are taking delivery services, but that these customers comprise a large percentage of eligible usage.

[11] The information provided in Table 3 was developed from data requests that Staff sent to each utility.
[12] NA = Not Applicable (the utility does not offer the service).

Table 4: Number and Percentage of Non-residential Customers Taking Delivery Services[13]

Utility	Total Eligible Customers	Delivery Services Customers	Delivery Services Customers (%)
AmerenCIPS	47,441	721	1.5
AmerenUE	8,622	0	0.0
CILCO	36,332	0	0.0
ComEd	329,367	21,567	6.5
Illinois Power	66,037	992	1.5
Interstate Power	2,532	0	0.0
MidAmerican	10,490	0	0.0
Mt. Carmel	968	0	0.0
South Beloit	933	0	0.0
Total	502,722	23,280	4.6

[13] Table 4 includes customers taking PPO service.

Table 5: Amount and Percentage of Non-Residential Customer Usage Taking Delivery Services

Electric Utility	Total Eligible Usage (Million mWh)	Usage on Delivery Services (Million mWh)	Usage on Delivery Services (%)
AmerenCIPS	3.8	1.0	26.3
AmerenUE	1.4	0.0	0.0
CILCO	3.1	0.0	0.0
ComEd	44.0	16.2	36.8
Illinois Power	9.8	3.5	35.7
Interstate Power	0.2	0.0	0.0
MidAmerican	1.1	0.0	0.0
Mt. Carmel	0.04	0.0	0.0
South Beloit	0.1	0.0	0.0
Total	63.5	20.7	32.6

IV. Structural Issues in Illinois Wholesale Electric Markets

This section identifies and describes structural problems and barriers to competition in wholesale markets. Current problems in the wholesale market derive from the structure of the wholesale market, where electric utilities, now functioning mainly as delivery companies and bundled retail electric service providers, are affiliated with the owners of much of the State's generating capacity; generator market concentrations; and, insufficient transmission capacity. Another structural issue is the lack of a transparent marketplace that would facilitate competitive activity, competitive entry, efficient resource allocation, and efficient resource expansion.

A. Issue: Wholesale Market Power

While wholesale prices are generally the domain of the FERC and most sales on the transmission system are wholesale in nature, the present state and structure of the wholesale market, and its ability to support a retail market, are of great concern. Without a competitive wholesale electricity market, retail competition—no matter how seemingly robust—will likely lead to inefficiently high prices. The existence of heavy generation ownership/control concentrations in

wholesale markets, transmission system capacity limitations, and affiliated interest concerns are all features of the current market that will contribute to market power issues in the Midwest's wholesale electricity market. Other issues include the lack of a transparent marketplace that would facilitate competitive activity, competitive entry, efficient resource allocation, and efficient resource expansion and also the inherent volatility of the wholesale market. Addressing these problems may require significant market restructuring.

1. Generation Ownership Concentration

The current wholesale electricity market in Illinois is characterized by highly concentrated generation ownership within utility control areas. In Illinois Power's territory, for example, Dynegy, Illinois Power's affiliate, owns about 79% of the total installed generating capacity.[14] Ameren Energy, Ameren's generation affiliate, owns roughly 83% of the capacity in AmerenCIPS' territory—and it will own 86% of the capacity in the combined AmerenCIPS and Ameren-CILCO territory if the merger is finalized.[15] Even in the ComEd service area, where ComEd's affiliate has up to this point limited itself to ownership of ComEd's former nuclear plants, concentration among the wholesale players is significant. Exelon Energy, ComEd's affiliate, possesses 32% of the total generating capacity in ComEd's service territory, and all the nuclear capacity, not counting resources controlled through contract. Midwest Generation, a non-affiliate that now owns ComEd's fossil-fueled plants, possesses 34% of the total generation capacity in ComEd's service territory, and all but a fraction of the base and intermediate load fossil fuel-fired generation capacity. In combination, therefore, Exelon and Midwest Generation together own almost all of the baseload and intermediate capacity in ComEd's territory. Furthermore, ComEd has entered into an arrangement with its affiliate to be the sole supplier of power—this puts the ComEd market into an even higher position of concentration if the measure is all generation owned or controlled by Exelon, rather than just the plants owned.

Furthermore, transmission import capability into the various Illinois utility control areas is quite limited in relation to the load to be supplied. Transmission import capability limitations perpetuate the high generation ownership concentration conditions within Illinois utility control areas.

These high levels of generation ownership concentration present a concern because concentration is a major factor that can enable power sellers to manipulate the market and artificially raise prices to the detriment of consumers. Suspicions of such activity, for example, arose in the concentrated California energy market during 2000 and 2001. Where market concentration is high, a simple act such as prolonging maintenance outages at one plant can provide all suppliers with significant unearned profits from higher prices for energy provided from the remaining plants. The FERC Staff recently concluded, for example, that artificially prolonged maintenance at a California generating plant allowed a

[14] Sources: EIA Forms 860A, 860B and 861; FERC Form 1; and "IL EPA Electric Power Plant Construction Projects Since 1998".
[15] Source: Docket No. 02-0428.

company to "collect more money, about $10 million, by running alternative units" during the California energy crisis.[16]

While generation capacity installed by independent energy companies has increased in the State, most of this has been peaking capacity. For example, in ComEd's territory, if current generation expansion trends continue, baseload's share of the capacity mix, which was 80% in 1998, will be reduced to 50% by 2004.[17] In comparison with baseload plants, peaker plants are generally cheaper to construct, but more expensive to operate, so they typically run during a limited number of hours of the year. This means that peakers, despite their growing share of rated capacity, represent a very small share of the total kWh of energy produced in a given year. For example, although gas-powered units (which are typically peaking units) made up 17.7% of the Midwest's capacity in 2001, they produced only 5% of total energy output. Oil-fired peakers represented roughly 4% of total generation capacity in the Midwest, but only accounted for roughly half of one percent of total electricity output in 2001. Nuclear power plants, on the other hand, constituted 5% of total capacity, but accounted for 16.9% of output. While coal plants, which represent 62% of the Midwest's generation capacity, produced 76% of the Midwest's electricity output in 2001.[18]

These numbers indicate that, in markets like the ComEd market, where the development of generator competition has been limited to the peaker segment of the market, the summer peak price will likely be lower than it would be in the absence of such generation competition. However, the baseload generation market, the source of the majority of the power produced and the market that sets the off-peak price, has remained heavily concentrated. In such a market, there is a concern that off-peak prices—while constrained to less than peaker generation costs—will be higher than they would be if more robust competition between baseload and intermediate generation existed. In other markets, where market concentration is high at every level of generator capacity, prices may be subject to influence during longer periods of time.

2. Sole-Supplier Contracting

Sole supplier contracts are another source of potential market power in the Illinois market. While not a concern under the rate freeze, as of 2007 whatever competition does exist in a given Illinois generation market will be compromised by the current use of sole-supplier contract arrangements between the utilities and their energy affiliates and/or holding companies. The sole-supplier function, by forcing all purchasing through the holding company/affiliate, creates a functional, affiliated monopoly supplier for each utility. Sole-supplier contracts are thereby a means of eliminating direct wholesale competition for a utility's business.

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[16] Platt's Electricity Utility Week, Nov 18, 2002, p. 1 and pp. 10-11.
[17] ICC Docket No. 02-0479, McNeil and Sterling Direct Testimony, p. 10.
[18] Source: "Midwestern Energy Infrastructure Assessment," Office of Market Oversight & Investigations, Federal Energy Regulatory Commission, Docket No. AD02-22-000, October 2002 .

3. Transmission Infrastructure Inadequacy and Barriers to Suitable Expansion

One of the major factors contributing to the development of competition at the wholesale level is the ability of the transmission system to move power within and between control areas. Transmission limitations directly impact the amount of competition that can occur at the wholesale level within and between each utility territory. As seen in other wholesale power markets -- such as the PJM, New York and California markets, for example -- constraints, by limiting competitive access to markets, tend to impact the ultimate price, and the volatility of prices, for power available to both wholesale and retail customers.

The presence of congestion on the transmission system indicates a system that is hitting its limit in its ability to move power from sellers to buyers. Periods of congestion are also indications that the various parts of the transmission system have become isolated from each other. These periods of market isolation and limitations in transmission reduce the number of competitive suppliers that can reach and compete in a given area. Simply put, an inadequate transmission system prevents low-cost power supplies from reaching markets, thereby allowing generators that can reach those markets to charge relatively high prices.

Nationally, the ability of the current transmission system to support a competitive wholesale market has recently come into question.[19] In the Midwest, evidence is accumulating that the MAIN region's system may be limited in its ability to facilitate a competitive wholesale regional market. Despite sporadic efforts to increase transmission capacity, congestion, measured in Transmission Load Relief ("TLR") events, has been trending upward in MAIN over the last 4 years. From the summer of 1999 to the summer of 2000, the incidence of TLR increased 472% in the Midwest.[20] Each TLR event represents a transaction between buyers and sellers of electricity that has been canceled, despite assignment of transmission rights, to prevent the transmission system from breaking down. Each TLR is indirect evidence, if not proof, that the current transmission system is not sufficient to support transactions created by the developing wholesale market for electricity.[21] However, even when TLRs are not needed to preserve transmission system integrity, economic power supply transactions may still be prevented from taking place by inadequate transmission capacity.

Unfortunately, transmission management, planning and expansion in the Midwest is a slow, disjointed process, potentially marred by affiliated entity

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[19] The North American Reliability Council ("NERC") reported that "the adequacy of the bulk power transmission system has been challenged to support the movement of power in unprecedented amounts and in unexpected directions. Energy Information Administration, "The Changing Structure of the Electric Power Industry, 2000: An Update," Chapter 7. URL: http://www.eia.doe.gov/cneaf/electricity/chg_stru_update/chapter7.html#ferc

[20] FERC Docket No. RM01-12-000, p. 36.

[21] The increase in TLRs may also be a result of market manipulation and oversubscribing of the transmission system for financial gain by the transmission providers.

conflicts of interest. As noted above, electric utilities, with their own market interests, are largely responsible for the determination of their available transmission capacity, what needs to be built, when it will be built, and how much it will cost. Rather than examining the transmission system as a regional grid, and working to find solutions to regional transmission limitation and flow problems, each transmission owner is concerned with its own grid and the effects any changes will have on its own and its affiliates' generation supply profitability. Such an outlook does not favor transmission expansion that would increase competition for its generation affiliate. Nor does it favor a transmission owner pursuing transmission upgrades on its own system to benefit neighboring and regional network systems, regardless of the overall benefit to the market.

As with many problems in the wholesale power market, FERC is attempting to put in place reforms that may help with transmission system congestion problems, by, for example, encouraging transparent market-based congestion management mechanisms. However, the underlying problem is structural and can best be addressed through structural remedies—principally transmission construction. These structural solutions are best shared between FERC and the states.

4. Lack of Independence Between Transmission Functions and Market Interests

The affiliated relationships that exist between Illinois utilities and their unregulated affiliates and holding companies creates the incentive and the ability to discriminate against unaffiliated wholesale market entry. Whether the transmission owners will be able to slow entry, limit outside access, or stop entry altogether, the incentives present under the current system work to sustain the current high concentrations in wholesale generation.

The FERC Order 888/Order 2000/ SMD NOPR series has been aimed at developing behavioral remedies for this affiliated interest problem. Order 888 required utilities to provide wholesale open access. Order 2000 encouraged transmission-owning electric utilities to transfer functional control over their transmission facilities to an independent regional transmission organization. FERC's SMD NOPR would mandate transfer of functional control of transmission facilities to an independent entity as well as establishing a standard transmission service and standard market design operated by an RTO.

Similarly, the General Assembly included Section 16-119A in the 1997 Amendments, which authorized the Commission to adopt a rule concerning standards of conduct between an electric utility's transmission/distribution systems on the one hand and its generation/sales functions on the other.

Nevertheless, while these policy efforts at the state and federal level have likely done some good, the affiliated interest problem in the electric industry is just too big to be successfully dealt with through behavioral remedies such as those described above. For example, even full implementation of FERC's Order 2000 and SMD NOPR would permit electric utilities to continue to own both transmission and generation facilities and to participate in both wholesale and

retail sales functions. While transmission operations are supposed to be under the control of an independent entity—the RTO—actual transmission system operation will continue to be conducted by the an electric utility affiliated with generation and market interests. Such an arrangement will leave many residual ways for the wires utilities to continue to advantage its own or its affiliates' generation/sales interests.

The difficulty in detecting discriminatory treatment is that the utilities have an information advantage over market participants and regulators. For example, only the transmission owners have the information to determine the amount of available transmission is on a given day, the requirements and costs for interconnection at a given point, etc. The FERC has noted that while there have been complaints, "instances of actual discrimination may be undetectable in a non-transparent market…is often hard to determine, on an after-the-fact basis, whether an action was motivated by an intent to favor affiliates or simply reflected the impartial application of operating or technical requirements."[22]

Even the perception of discriminatory treatment caused by affiliate relationships between generation and transmission can deter the development of competition. The FERC notes, "perceptions of discrimination are significant impediments to competitive markets…[e]fficient and competitive markets will develop only if market participants have confidence that the system is administered fairly." [23] The mere perception of discriminatory treatment from a transmission owner towards non-affiliates "may also deter generation expansion and lead to the perception that the transmission provider's generation is more reliable, thereby reducing competition and raising prices for customers."[24] The Commission shares the FERC's concern that the current lack of independent transmission ownership and operation, and its associated incentives to treat unaffiliated market interests in a discriminatory manner, will limit wholesale competition and entry, helping to maintain market concentration, high prices, and the duration of cyclical and spontaneous price spikes.

B. Issue: Absence of a Transparent Marketplace

Transparency in the wholesale market would greatly facilitate the development of a competitive wholesale market for electricity in the Midwest. For an instantaneous market, such as the one for electricity, to efficiently operate buyers and sellers in the wholesale electricity market need an easy way to find each other, an easy way to compare prices and offers, and a way to get the product from the seller to the buyer. In general, the information and liquidity requirements necessary to support a truly competitive electricity market, particularly one that includes retail access, are particularly steep relative to those that have historically served the vertically integrated utilities under regulation. The FERC has recognized the need for greater transparency in wholesale

[22] FERC, State of the Markets 2000. p. 17.
[23] FERC Order No. 2000, at 31,017.
[24] Ibid.

markets in its recently released Standard Market Design NOPR.[25] The basic characteristics of a transparent wholesale market can be summarized as follows:

(1) A real-time and day ahead offer-based energy market using Locational Marginal Pricing, incorporating a generator unit commitment process to ensure that sufficient generation is online or available day-ahead for reliable operations;

(2) real-time ancillary services markets, also using LMP;

(3) an LMP-based congestion management system that uses the day-ahead and real-time markets to maximize use of the transmission grid and determine congestion charges;

(4) a set of financial congestion hedges, called financial transmission rights (FTRs);

(5) a capacity or reserve requirement;

(6) a market-driven grid expansion protocol;

(7) a market monitoring unit with a market power mitigation program.

This suite of information tools and processes are considered necessary by the FERC to promote wholesale competition.[26]

C. Issue: Cyclical and Spontaneous Price Volatility in the Wholesale Market

Potential cyclical and spontaneous price volatility in the wholesale electricity market is another concern under a restructuring electricity market. In a competitive market, prices reflect the interaction of supply and demand. This will lead to both cyclical and spontaneous price volatility in electricity markets, however, because supply is relatively fixed in the short term and demand fluctuates greatly. Transmission limitations, generation concentration, and the capital intensive nature of the generation industry will tend to limit supply at one time or another and make the price of electricity volatile both spontaneously in the spot market and cyclically over investment cycles. Instances of transmission congestion and corresponding supply shortages have been directly related to spontaneous price spikes and price differentials in electricity energy markets. This has been readily seen in California, PJM, and NYISO. In California capacity shortages, transmission congestion, unprecedented demand levels, and gaming of the system combined to create extreme and enduring price spikes in the California wholesale market for electricity. In PJM and NYISO, transmission congestion regularly causes periodic price spikes during peak demand periods and short-term capacity shortfalls. Such volatile prices, while perhaps painful to electricity consumers, can send necessary signals to market participants. In particular, they signal buyers to demand less and suppliers to supply more.

[25] FERC Docket No. RM01-12-000.
[26] Ibid., pp. 65-68.

While price volatility in such a market is to be both expected and a natural part of the interaction between supply and demand over time, dramatic and unexpected price changes can introduce economic instability and opposition to restructuring efforts.

V. Barriers to Illinois Retail Electric Markets

Potential barriers to competition in the retail market include the existence and volatility of transition charges, a lack of supplier interest in serving smaller-use customers, the PPO (in the service territories in which it is offered), and the reciprocity provisions that restrict the pool of potentially qualified suppliers.

A. Issue: Transition Charges

The 1997 Amendments permit electric utilities to levy transition charges on customers who switch from bundled service to delivery services, either by taking power from a RES or purchasing power under the PPO. Only the Ameren companies, ComEd and IP have tariffs in place permitting them to impose transition charges.[27]

The 1997 Amendments use a lost revenue concept to derive the level of transition charges that utilities may impose on delivery services customers. Under this approach, the calculation of transition charges permits utilities to expect to recapture through the transition charge essentially all revenue lost when a customer purchases power from an alternative supplier or through the PPO, less a percentage of the customer's bill known as the "mitigation factor."

The mitigation factor enables a customer of a utility imposing transition charges to anticipate savings by switching to delivery services because the mitigation is essentially a credit against applicable transition charges. The mitigation factor was initially set at 8% of the customer's base rate, and rises to 10% in 2003. By switching to delivery services, an average customer can only expect to save the amount of revenue represented by the mitigation factor percentage. Customers for whom 8-10% savings represents an insignificant amount of their electric bill probably will not seriously consider switching. Customers whose usage pattern varies significantly from the usage pattern of the customer's entire rate class may not be able to achieve any savings.

Because of the method by which transition charges are calculated, whether competition grows or takes a step backward depends largely on market values. In periods when market values are high relative to the cost of generation implied in bundled rates, transition charges limit even the small savings potentially available to customers. When market values are low, and the difference between the generation component and the wholesale market price is large (as was the case during 2001-2002), the potentially large gains from competition are severely diminished. The volatility of transition charges has

[27] Ameren has proposed to eliminate transition charges for at least two years, starting in mid-2003 (Docket No. 02-0657).

retarded retail competition in the service areas where utilities impose transition charges on customers who switch to delivery services.

Moreover, the yearly variability of market values and transition charges has made customers wary of signing long-term contracts. The problem of unpredictable transition charges was particularly acute during 2001-2002, when transition charges for some customers approximately rose an amazing 15-fold. In response to these increases, many customers will return to bundled services as soon as their supplier contracts expire, and may choose to remain there to avoid further uncertainty.

Table 6 lists examples of transition charges that utilities collect from three categories of non-residential customers (these charges are only approximate). The "Small Commercial" customer generally refers to a customer whose electric consumption is measured with a watt-hour meter only; a "Mid-Size Commercial" customer generally has a demand between 400 kW and 800 kW; and, the "Large Industrial" customer has a demand greater than 1 MW.

Table 6 shows that only three utilities imposed transition charges in 2002. The table also shows that transition charges are generally greater for small customers than for large customers, which may help to explain why a higher percentage of large customers than small customers are taking delivery services. Finally, the table shows that transition charge payments to utilities can be significant.

Table 6: Representative Customer Transition Charges and Total Transition Charge Revenue Collection[28]

Electric Utility	Small Commercial Customer (Cents per kWh)	Mid-Size Commercial Customer (Cents per kWh)	Large Industrial Customer (Cents per kWh)	Transition Charge Revenues Collected, 1999-2001 ($ Millions)[29]
AmerenCIPS	2.2	0.5	0.0	2.6
ComEd	4.1	2.3	2.1	267.1
Illinois Power	5.0	1.0	0.6	21.7
All Others	0.0	0.0	0.0	0

[28] The transition charges listed in the table are taken from tariffs filed with the Commission.
[29] Source: "Report to the General Assembly: Summary of the Annual Reports Filed by Electric Utilities Required by Sec. 16-130 of the Electric Service Customer Choice and Rate Relief Law of 1997," Illinois Commerce Commission, October 2002.

B. Issue: Rejection of Commission Market Value Decisions

As explained above, the current method for developing transition charges relies on calculation of market values. These calculations are also used to set the price of generation for PPO service. After 2007, market values might also be used to set the cost of the generation component of the rates applicable to customers purchasing their power and energy from the incumbent utility.[30]

Sec. 16-112 permits the use of two methods to develop market values. Under the default methodology, a third-party selected by the Commission, known as the "Neutral Fact Finder," develops market values based on summaries of contracts entered into between participants in both retail and wholesale markets. The NFF process is used unless a utility successfully petitions the Commission to allow it to use a method that develops market values "as a function of an exchange traded or other market traded index, options or future contracts or contracts applicable to the market in which the utility sells, and the customers in its service area buy, electric power and energy…"[31]

Since 1999, both the NFF and the market index methods have been used to develop market values. After the NFF was used twice, the Ameren companies, ComEd and IP, with the Commission's authorization, now use a market index approach that relies on measures of wholesale trading activity. Despite efforts by many parties, however, no method has produced entirely satisfactory results. Moreover, there have been seemingly endless arguments over adjustments that parties have contended are needed to reflect "true" market values. One major source of disagreement concerns the extent to which the costs and risks that suppliers incur in serving retail customers, such as marketing costs, congestion risk, credit risk and imbalance risk should be included in the market value calculation. Until such disagreements are resolved with finality, suppliers and customers will be reluctant to enter into long-term power and energy arrangements.

While the Commission has the authority to rule on adjustments to the market values proposed by various parties in the proceedings through which the market value methodologies are established, Sec. 16-112 has been construed to mean that a utility that does not wish to accept the Commission's adoption of these adjustments can refuse to implement them. Any utility's refusal to accept the Commission's market value ruling means reversion to the NFF process. Since the NFF process requires every party who traded power in both Illinois wholesale or retail markets to provide the NFF with a contract summary, most participants are quite reluctant to advocate the use of the NFF process. This requirement leaves any utility proposing a market value methodology with a bargaining chip against what it might believe are adverse Commission decisions, leaving the Commission in a position of only making the type of rulings that it believes a utility would likely accept.

[30] See Sec. 16-103(c) and Sec. 16-111(i).
[31] Sec. 16-112(a).

C. Issue: The PPO as an Obstacle to Retail Competition

The PPO is an unbundled power and energy service that electric utilities that assess transition charges on delivery services customers must offer to non-residential customers. Customers taking PPO service pay a generation charge priced at the market value, a delivery charge, an administrative fee, and a transition charge. The existence of the mitigation factor ensures that most (but not all) customers would pay a lower total electric bill than they would under the full bundled rate. Customers for whom transition charges are zero are ineligible for the service.

Unexpectedly, the PPO has become the most popular service offering in two of the three service areas in which it is offered (AmerenCIPS and Illinois Power) and is about as equally as popular as RES supply in the ComEd area, where about 40% of delivery services customers take the PPO. In the Illinois Power service area, in fact, the PPO is so popular relative to RES supply that less than 1% of IP delivery services customers are purchasing their power and energy from a RES.

In retrospect, the popularity of the PPO perhaps should not have been surprising. From a customer's point of view, the PPO is simply a rate discount from the bundled rate. Many customers considering delivery services can expect to save about as much on their electric bills by signing up for the PPO with the utility as they could by purchasing power from a RES (less an administrative fee), without having to establish a business relationship with an unfamiliar entity. The PPO is especially important to customers in the areas where suppliers are not actively soliciting customers.

From a supplier's perspective, the PPO can present a big obstacle to acquiring new customers. Many suppliers view the PPO as another method through which incumbent utilities maintain the ability to serve customers with power and energy when utility PPO customers might otherwise switch to RES power supply. In effect, the PPO represents a highly efficient, low-cost supplier that has a direct line to customers.

To acquire customers and beat the PPO price, suppliers must be able to acquire power at a rate that is lower the level of the market value to attract customers (or hope that the market price of power drops after it is fixed through the market value process), and expend the resources needed to market to customers. As a result of these difficulties, many suppliers have used the PPO as a supply source, either through reselling the PPO as an agent or through "PPO Assignment," as a means to attract customers.[32] While this strategy can limit a supplier's risk, it is not especially remunerative, as the suppliers using the strategy can expect only very low profit margins from its use.

From a long-run competitive point of view, it would probably be preferable to have delivery services customers taking RES service rather than PPO service, since the PPO will only be offered until the end of the transition period. At that

[32] See Sec. 16-110 (b).

point, customers receiving rate cuts by taking PPO service will have to switch to a RES if they wish to continue receiving savings.

D. Issue: Reciprocity Requirements of Sec. 16-115(d)(5)

Sec. 16-115 contains requirements that all non-utility suppliers must meet if they wish to provide service to retail customers. This section contains the "reciprocity" provisions, which require an applicant to verify that it and/or its affiliate are located within a state that has adopted a customer choice program comparable to the program in effect in Illinois. These provisions constitute a direct and obvious barrier to the development of retail electric competition.

Because such requirements limit the size of the potential pool of competitors, the reciprocity provisions can be seen as an impediment to the growth of competition. Reciprocity restrictions lessen competitive pressure on those suppliers who do enter the market and, in so doing, may limit innovation and product development.

Adding more suppliers in the retail market would have beneficial effects on the wholesale market, as the presence of vigorous retail competition may mitigate the volatility of the energy market.

E. Issue: Lack of Supplier Interest in Serving Residential Customers

Suppliers have shown little interest in serving residential customers. Most observers had expected little supplier interest in serving small-volume customers except perhaps by the suppliers participating in the two natural gas small-volume customer choice programs. However, even the suppliers participating in these programs have not shown an interest in serving residential customers.

A supplier's potential small profit on each residential customer it serves explains why suppliers may be reluctant to serve small-volume customers. The average residential customer used about 8,500 kilowatt-hours of electricity in 2001, at a cost (including delivery charges) of $739. At a kWh cost of $0.025/kWh, the average residential customer pays about $210 annually for the commodity of electricity only.[33,34] The expected profit for a RES serving the average residential customer would be about $10-20. Clearly, suppliers considering serving residential customers would need to serve thousands of customers, or to sell other products in addition to electricity, to make electricity sales to small-use customers a worthwhile endeavor.

VI. Recommendations

This section lists recommendations that the Commission believes would address some of the impediments to wholesale and retail competition identified in

[33] Source: Illinois Commerce Commission report, "A Comparison of Electric Sales Statistics For Calendar Years 2001 and 2000", available at http://www.icc.state.il.us/ec/electricity.aspx.
[34] Using the same methodology, a small commercial customer spends about $1,875 and an industrial customer about $310,000 on electricity during the course of a year.

the previous section. Implementing these recommendations would likely require action by the General Assembly.

Recommendation 1. Require Illinois Utility Membership in Properly Designed and Configured RTOs

Discussion: Transmission owners must belong to an independent regional transmission organization ("RTO") in order to address problems caused by both the lack of regional transmission planning as well as the market power issues stemming from a lack of independence of the transmission operator from affiliated market interests. At the present time, transmission owners in Illinois are required by Sec. 16-126 of the Act to belong to Independent System Operators. This obligation should be updated and expanded to require Illinois utility transmission owners to belong to regional entities that adopt and adhere to particular market design criteria.

At a minimum, an RTO should exercise independent overview of interconnection of new generation, calculation of available transmission, allocation of transmission rights, congestion management, and need for transmission upgrades. Independent RTO oversight would go a long way towards addressing issues associated with affiliated interests and market power. Further, independent RTO administration of transmission planning and expansion would help regional wholesale market development, which would expand the pool of wholesale resources that could compete in Illinois over time. The independent RTO is the logical entity for coordinating both transmission system operation and real-time wholesale power market operation.

Given the benefits that properly designed RTOs would bring to the markets, the Commission recommends that the that Illinois electric utilities should be required, by expansion of Sec. 16-126 language and other appropriate Public Utilities Act language, to join a FERC-approved RTO which maintains certain minimum standards for wholesale market design. In particular, the RTO should operate real-time wholesale power markets based on a design featuring centralized, bid-based, security constrained, least cost dispatch. A regional RTO that maintains these necessary market design criteria would address the problems caused by a lack of a transparent marketplace in Illinois. FERC-approved RTOs operating in Illinois should, accordingly, possess the suite of information tools and processes that would more easily facilitate the development of a competitive wholesale market. This would include market based congestion management and transmission allocation, as well as price signals to potential entrants.

In addition to combating market power, conflict of interest, and transparency problems, transmission owners belonging to a regional RTO would make significant strides toward establishing coherent and timely price signals to consumers and potential suppliers. An important part of any market is the ability of consumers to modify their demand to changes in prices. An RTO-operated congestion management system would, through the use of LMP spot prices, provide short-term price information to market participants about the periods

when prices are high. Customer ability to respond to such information would reduce some of the spontaneous volatility in electricity prices. These same price signals would also indicate the most likely locations for future load growth and the best locations for new generation, thereby mitigating cyclical price volatility. RTO management and oversight of generation interconnection would further facilitate the development of competitive wholesale entry during periods of capacity shortage. In addition, RTO management and oversight of transmission planning and expansion would ease congestion that causes a significant portion of spontaneous volatility in wholesale markets and can lead to higher retail prices. In short, development of a properly designed and properly configured RTO overseeing transmission system operations and managing a common transparent wholesale power market throughout the Midwest region would go far to address current problems in the electricity markets.

Recommendation 2.: Readdress Functional Separation Issues

Discussion: The General Assembly is encouraged to further improve the behavioral remedies that have already been initiated. In particular, Sec. 16-126 of the Act concerning independent system operators and Sec. 16-119A of the Act concerning standards of conduct/functional separation should be revisited to improve the Commission's ability to use those behavioral remedies to support further development of competitive markets in the absence of structural reform.

Recommendation 3.: Allow New Transmission Investments on the Basis of the Promotion of Competition

Discussion: In order to promote pro-competitive transmission upgrades and projects, whether they are proposed by RTOs or utilities, Sec. 8-406 of the Act should be modified to allow a certificate to be granted where such transmission upgrade or project can be shown to promote competition in the wholesale market. As it now stands, Sec. 8-406 of the Act requires public utilities to obtain a certificate from the Commission before commencing construction of transmission facilities. Sec. 8-406 states that the Commission shall issue such a certificate only if the facility will "promote the public convenience and necessity." While the Section goes on to state the factors that must be found by the Commission to support such a finding, the promotion of competition is not among those factors despite the fact that Sec. 16-102 of the Act directs the Commission to promote a competitive power market.

Recommendation 4.: Greater Oversight of Utility Asset Transfers

Discussion: To address the problem of market concentration, and to prevent a mere changing of the title of ownership of ready-made generation monopolies during any required or voluntary divestiture, the Commission should have the authority to review, approve, deny, or condition utility asset sales to affiliates or non-affiliates. In the 1997 Amendments, the General Assembly adopted Sec. 16-111, which, among other things, authorized Illinois electric utilities to transfer assets to affiliates or non-affiliates with relatively little Commission oversight.

This statutory provision allows the generation ownership concentration that was developed under a comprehensive regulatory regime to continue undiluted into the new era in which policy-makers are attempting to facilitate competitive markets. Indeed, this statutory provision could permit generation ownership concentration levels to increase precisely at the time when competitive market development depends upon concentration decreasing. The Commission should be required to examine any such sale in light of the probable effect on the competitive wholesale market and the ability of the potential owner to exercise market power or otherwise engage in strategic behavior in the electricity market. Should the Commission determine that such a threat does exist from the proposed sale, divestiture, or assignment of generation assets to on or more parties, the Commission should be provided the authority to deny the sale or condition the sale such that the threat of market manipulation is mitigated or eliminated.

Recommendation 5.: Require Competitive Bidding for Bundled Supply

Discussion: While the Commission has the authority to review a utility's purchases for prudence, determining prudence in the absence of competitive bids from many potential suppliers will be difficult. To help insure that retail customers can enjoy the potential benefits of developing wholesale competition, the Commission should have clear authority to address how the utility purchases power. One way to provide for prudence review, and to allow a pass-through of any benefits from a competitive marketplace, would be to require the utilities to make use of open bids auctions to acquire wholesale supply. In addition, all terms and bids, and the end result of the auction, would all be subject to prudence and market monitoring review by the Commission.

Recommendation 6.: Modify Sec. 16-111 to Permit the Commission to Set Non-discriminatory Stand-by Rates

Discussion: In addition to the structural and behavioral reforms mentioned above, the remedies for mitigating electricity price volatility should include removing the discriminatory treatment of distributed generation as a means of demand response.

Distributed generation typically refers to generation that is connected to or injected into the distribution level of the electric transmission and distribution grids on either the customer side or utility side of the meter or elsewhere on the distribution grid. Distributed generation is most commonly sited and owned by the customer, connected on the customer side of the meter, runs in parallel with a utility's distribution system and supplies some, or all, of the customers' electricity needs. Distributed generation can also be interconnected to the utility side of the distribution system, supplying all of its output to the grid. Distributed generation includes combined heat and power applications, fuel cells, natural gas micro-turbines, wind turbines, landfill gas recovery systems, photovoltaic cells and other small generating units.

Distributed generation can potentially contribute to the development of a competitive marketplace for electricity in Illinois. Distributed generation can reduce peak system demand, provide demand flexibility for customers, increase system reliability and provide a competitive check on retail electricity markets. Distributed generation can supply electric utility distribution networks with additional power that can be used to serve the needs of other customers on the distribution network. Strategically placed distributed generation can be used to relieve congestion and avoid costly transmission and distribution upgrades by serving load on circuits that are behind constrained paths.

Distributed generation interconnection applications, procedures, studies and fees are not specifically addressed in Illinois administrative codes or legislation. Currently, there is a rather disjoint patchwork of interconnection procedures, stand-by or backup charges, and study fees that often discourage customers from considering distributed generation as a substitute or complement to traditional electric supply. In some cases, interconnection procedures, interconnection study fee schedules, and standby rates are unnecessarily onerous and act as barriers to what may otherwise be an efficient application of distributed generation. Notwithstanding any prohibition against changing rates during the current rate freeze, the Commission should be permitted to investigate and set fees and rates for each electric utility to ensure that interconnection study fees and standby rates do not discourage customers from considering the implementation of distributed generation.

Recommendation 7.: Do Not Permit Electric Utilities to Reject Commission Market Value Decisions

Discussion: The utilities' ability to effectively reject Commission decisions means that the Commission could be prevented from instituting policies that it believes could enhance competitive markets, such as requiring utilities to calculate individual transition charges for customers other than the largest customers only; setting transition charges for multiple years; setting transition charges to more closely reflect the rises and falls in the power prices on the wholesale markets, etc**.**

Recommendation 8.: Modify the Public Utilities Act To Permit Electric Suppliers To Use Telemarketing-Based Customer Enrollment Methods

Discussion: Long-distance phone companies and natural gas suppliers can use telemarketing methods to enroll customers, but the Commission has recently ruled that telemarketing methods as a means to enroll electric customers are not consistent with the Act and the Consumer Fraud and Deceptive Business Practices Act.[35] If appropriate safeguards against unauthorized switching can be

[35] The Commission approved a rule that allows suppliers to use electronic signatures as means to enroll customers over the Internet (Docket No. 02-0290).

put in place, electric suppliers should be able to use the same enrollment methods as suppliers selling other utility services.

Recommendation 9.: Eliminate the 24-month Minimum Enrollment Requirement in Sec. 16-103(d).

Discussion: The delivery services tariffs applicable to non-residential customers typically require delivery services customers who wish to switch back to bundled service to remain on that service for one year. The purpose of this requirement is to prevent customers from switching to delivery services when wholesale prices are low, but switching back to the utility when wholesale prices are relatively high. The limitations on the frequency with which customers may switch to and from bundled service may enable utilities to minimize the potential acquisition costs imposed on them for standing ready to serve bundled customers.

However, while the Act does not impose any particular requirement on a utility's right to require large-use customers to remain on bundled service for any definite period, Sec. 16-103(d) allows electric utilities to prevent residential customers and commercial customers consuming less than 15,000 kWh annually who return to bundled to remain on bundled service for up to 24 months. In the Commission's view, this requirement could is unfair. Moreover, the requirement could be eliminated at virtually no cost to utilities, since no residential customers have yet switched and therefore electric utilities must continue to plan to serve their entire residential load in the same way they always have. Moreover, even if residential customers began to switch, the combined usage of a handful (or even hundreds or thousands) of residential customers is so small relative to the usage of all residential customers that a utility would still plan to serve virtually its entire residential load.

Recommendation 10.: Consider Implementation Of Municipal Aggregation

Discussion: Municipal aggregation programs may provide the best avenue to jump-start the residential electric market. These programs have been implemented in other states, most notably Ohio, with some success. As tried in other states, municipal aggregation programs generally permit the residents of the municipality to permits the municipality's governing body to select the electric supplier or suppliers that will provide the power and energy portion of electric service to the municipality's residents. Customers, however, generally have the option of remaining with the incumbent utility or switching to another alternative supplier.

Municipal aggregations programs appeal to many suppliers because transactions costs are spread out over a large number of customers, suppliers can combine the load shapes of smaller-volume customers with those of larger customers participating in municipal aggregation programs to create a load

shape that is easier to serve, and because customers may be more inclined to enter into long-term contracts.[36]

Pursuant to the direction of the General Assembly, the Commission is currently conducting a study evaluating the potential benefits of introducing the use of municipal aggregation programs in Illinois. This study should be concluded in the early in 2003. Unless the study concludes that municipal aggregation could have potentially serious negative impacts in Illinois, the General Assembly should modify the Act (if modification is necessary) to permit municipalities to create aggregation programs.

VII. Conclusion

Barriers to entry have hindered the development of Illinois wholesale and retail markets. Neither market can be considered to be competitive at the present and there is a serious question as to whether the markets will be competitive by the end of 2006, when the current rate freeze is due to expire.

The Commission's concern about the status of the wholesale market stems from the structure of the newly restructured Illinois electric industry. Holding companies now own or control most of the generating capacity in each service territory, as well transmission and distribution facilities. The Commission believes that the electric utilities can use their ownership of the delivery facilities to advantage their affiliated generators by discouraging independent generator entry into generation markets and/or increasing transmission import capacity. As a result, generator ownership is presently highly concentrated in most utility service areas, making price competition between generators unlikely. Other impediments to the development of a competitive wholesale market for electricity in Illinois include the lack of transparency in the current wholesale market design and the inherent volatility of wholesale markets.

It is vital to all to participants in the Illinois electric market that these problems be addressed as quickly as possible. The new entities now owning or controlling the generating plants formerly owned electric utilities are now supplying the bulk of the power and energy needed to serve both delivery services customers and the customers who will remain on bundled service. Thus, it is important that these entities operate in a competitive marketplace. As of the end of 2002, however, the Commission is not optimistic that the wholesale market will become reasonably competitive by the end of the rate freeze.

While the Federal Energy Regulatory Commission is charged with regulating the wholesale power market, the State has the ability to advance policies that will encourage wholesale competition. The Commission recommends that the General Assembly consider policies to increase the number of independent entities (including customers) that own generation in a

[36] For a discussion of municipal aggregation, see, for example, the report prepared by Nancy Rader and Scott Hempling for the American Public Power Association "Promoting Electricity Markets Through Community Purchasing: The Role of Municipal Aggregation" January 2000.

service area and also act to eliminate disincentives for needed expansion of the transmission grid.

The success of these policies will directly influence the development of retail competition in Illinois. Currently, retail competition has been, at best, uneven, and, in most service territories, nonexistent. Only in the ComEd area have a fairly large number of customers chosen to move from bundled service to service from an alternative supplier. Switching by customers in the State's next two largest service areas (AmerenCIPS and Illinois Power) mainly involves the PPO. Switching activity in all other service areas and among residential customers has been nonexistent.

In addition to an uncompetitive wholesale market, barriers to competition in the retail market include the existence and volatility of transition charges, the reciprocity provisions of the Act and the PPO. Transition charges limit the savings available to customers to approximately the mitigation factor" which may not be large enough to tempt many customers to switch. The Act's reciprocity provisions have discouraged suppliers from entering the market, or even made it impossible. The PPO is an obstacle to suppliers because customers can expect to obtain about the same amount of savings (less an administrative fee) by switching to the PPO as by purchasing power from a RES.

To address these obstacles, the Commission recommends adoption of policies that are designed to encourage customer and supplier interest in retail competition. The Commission also recommends adoption of policies that could stimulate interest among residential customers in retail competition.

Appendix

Table 7: Retail Electric Suppliers in Illinois[37]

Retail Electric Supplier	Illinois Utility Or Illinois Utility Affiliate?	Can Serve Which Customers?	Can Serve In Which Service Areas?
Ameren Energy Marketing	Affiliate (Ameren)	Non-residential greater than 15,000 kWh	All
AmerenCIPS	Utility	All	All
Blackhawk Energy Services	No	Non-residential greater than 15,000 kWh	ComEd, IP
CILCO	Utility	All	All
CMS Marketing, Services and Trading Company	No	Greater than one MW	All
Constellation NewEnergy (formerly AES NewEnergy)	No	Non-residential greater than 15,000 kWh	ComEd, IP
Duke Solutions, Inc. (relinquished certificate)	No	Greater than one MW	All except Mt. Carmel
Dynegy Energy Services, Inc.	Affiliate (Illinois Power)	Non-residential greater than 15,000 kWh	All
EnerStar Power Corp.	No	All non-residential	AmerenCIPS, CILCO, ComEd, IP
Enron Energy Services, Inc. (relinquished certificate)	No	Greater than one MW	All
Exelon Energy, Inc.	Affiliate (ComEd)	All non-residential	All
Illinois Power (no longer marketing)	Utility	Non-residential	All
Illinois Power Energy, Inc.	Affiliate (Illinois Power)	Non-residential greater than 15,000 kWh	All
Illinova Electric Partners	Affiliate (Illinois Power)	Greater than one MW	All except IP
MidAmerican Energy	Utility	All	All
Nicor Energy, LLC.	Affiliate (Nicor Gas)	All non-residential	All

[37] Data is current as of September 30, 2002.

Table 7 (Continued): Retail Electric Suppliers in Illinois

Retail Electric Supplier	Illinois Utility Or Illinois Utility Affiliate?	Can Serve Which Customers?	Can Serve In Which Service Areas?
Peoples Energy Service Corporation	Affiliate (People's Gas and Energy Company)	All non-residential	All
Sempra Energy Solutions	No	Non-residential greater than 15,000 kWh	ComEd
Sempra Energy Trading Group	No	Non-residential greater than 15,000 kWh	AmerenCIPS, ComEd, Illinois Power, and CILCO
South Beloit	Utility	All	All
WPS Energy Services, Inc.	No	Greater than one MW	AmerenCIPS, ComEd, Illinois Power, and CILCO